1-1973

Woman CPA Volume 35, Number 1, January, 1973

American Woman's Society of Certified Public Accountants

American Society of Women Accountants

TAX FORUM

BARBARA M. WRIGHT, CPA
Ernst & Ernst
Tampa, Florida

DISTRIBUTIONS FROM EMPLOYEE PLANS–TAX LAW CHANGES

This issue of the Tax Forum will review a recent "about-face" by the IRS regarding lump-sum payouts from exempt profit-sharing or pension plans and two 1972 changes in the tax law that will affect returns filed for that year.

Change in IRS Position

Employee Plans–Separation From Service

In Revenue Ruling 72-440, IRB 1972-38, the Service has reversed its earlier more liberal interpretation of Section 402(a)(2) and now takes the position that a distribution from a profit-sharing plan following an employer's reorganization will not qualify for capital gains treatment if the employee receiving the distribution continues in the service of the "new" employer. Previously, if the employer corporation ceased to exist as a result of a liquidation or reorganization, distributions received by an employee in one year from an exempt employees' trust were afforded capital gain treatment to the extent they exceeded his contributions. Despite the fact that the employee continued in the same capacity for the successor corporation, it was considered that he had terminated his employment with the corporation that went out of existence. Therefore, all three requirements of Section 402(a)(2) were met, i.e., total distribution received within one year on account of separation from service. Capital gain treatment, however, was somewhat limited in 1969 by the addition of Section 402(a)(5) which provides that post 1969 employer contributions are ordinary income when distributed.

Revenue Ruling 72-440 states that now "an employee will be considered separated from the service, within the meaning of Section 402(a)(2) of the Code, only on his death, retirement, resignation, or discharge, and not when he continues on the same job for a different employer as a result of the liquidation, merger, consolidation, etc., of his former employer." All previous revenue rulings contrary to this position are either revoked or modified to conform to the current rationale. However, the 1972 ruling will not be applied to deny long-term capital gain treatment to distributions made on or before September 18, 1972.

There may well be further discussion on this issue in light of a 1972 Sixth Circuit decision (Smith, et al, v. U. S., 29 AFTR 2d 72-1101) which contradicts the complete turnabout by the Service. In that case, Adkins Cargo Express, Inc., was acquired in 1965 by Gateway Transportation Co., Inc. During the same year, Cargo discontinued its qualified profit-sharing plan and trust, distributed its assets to participants, and in *1968* was merged into Gateway. Although Gateway continued to employ substantially all of the employees of Cargo, the Court found that there was a distribution on account of the employees' separation from service. In addition, the Court also stated that the fact that Cargo did not formally go out of existence until some three years after the distribution was not determinative. The controlling factor here was the intention of Gateway, at the time of the acquisition, to merge the two corporations when economically feasible.

Changes In Tax Law

Carryback of Current Year's Disaster Loss

H.R. 11185 (8/18/72) amends Section 165(h) of the Code to allow a taxpayer to elect to deduct disaster losses occurring in the current year from his income for the preceding taxable year. This amendment is applicable to disasters occurring after December 31, 1971, in taxable years ending after such date.

Congress has amended the Code permitting an extension of time in which to claim disaster losses mainly because of the extensive flooding in many parts of the United States during May and June of 1972. In prior years, Section 165(h) applied only to losses occurring before the due date of the income tax return (without extension). For calendar year individuals and corporations, this meant anytime prior to April 15th and March 15th, respectively. This special rule has now been amended to qualify any catastrophe taking place after December 31, 1971, and means that "Agnes" and other 1972 natural disasters may be claimed as deductions on 1971 tax returns. The new extended period is available to all taxpayers, corporate and individual. The carryback of the deduction, which is at the election of the taxpayer, applies only to casualties in regions officially designated as disaster areas by the President. Filing the refund claims on Form 1040X for individuals and 1120X for corporations will assure the most expeditious action by the Treasury.

Proposed Regulation 1.165-11(e) provides the time and manner of making an election to claim a deduction with respect to a disaster loss occurring after December 31, 1971. In general, this election must be made on or prior to the later of (1) the normal due date of the return for the year of the disaster (*without* regard to extension), or (2) the due date of the previous year's return *including* any applicable extension time. The election shall be irrevocable 90 days following the date made or 90 days after final regulations are published if that is later. Should a taxpayer decide to revoke an election, he would be required to repay any credit or refund resulting from the election within the 90-day period.

The new amendment should be beneficial to many who have suffered disaster losses as it will enable them to obtain a quick refund at a time when they are most likely to need cash to repair or replace damaged property. There is a special provision allowing refunds in excess of $100,000 to be made *before* the report required by Section 6405 is sent to the Joint Committee on Internal Revenue Taxation. This Code section provides generally that no refund of taxes in excess of $100,000 shall be made until thirty days after a report containing all pertinent facts has been submitted to the Joint Committee. New Subsection 6405(d) eliminates this waiting period and should benefit large corporations that have had to suspend operations because of extensive plant damage by providing immediate funds with which to resume production. However, as noted above, once the election is made, it will be binding within 90 days. Therefore, the taxpayer should, if possible, project his current year's earnings in order to determine whether the tax savings will be greater if the deduction is taken in the year the disaster occurs. The importance of this point may be emphasized by the following example:

Corporation A with a fiscal year ending September 30, 1972, suffered a loss in June of $20,000 resulting from extensive flood damage. The corporation had paid a tax of $5,500 on its prior year's taxable income of $25,000. Should the loss be claimed as a deduction for that year, the company would receive a tax refund of $4,400 ($20,000 × 22%). Due to a production shut-down, the current year's taxable income from operations is only $5,000. However, in order to obtain funds for the replacement of low-basis plant facilities destroyed in the flood, Corporation A has also recognized $40,000 of long-term capital gain from the sale of marketable securities. Tax on total income of $45,000 at alternative rates would be $13,100 ($5,000 × 22% + $40,000 × 30%). By applying the $20,000 casualty loss in the present year, the tax liability would be $5,500 ($25,000 × 22%), a reduction of $7,600 or an overall savings of $3,200 in the two years.

	Tax Liability 9/30/71	*Tax Liability 9/30/72*	*Total Tax Liability*
Loss Applied 1971	$1,100	$13,100	$14,200
Loss Applied 1972	5,500	5,500	11,000
Tax Savings			$ 3,200

Rental Vacation Property

The new Regulations under Section 183 which were adopted in July, 1972, not only affected the wealthy "hobby loss" farmer, but they also reduced the tax benefits available to vacation homeowners who rent their property for some part of the season. Under Regulation 1.183-2(b)(9), the renting of a summer house, for example, is treated as an activity not engaged in for profit since the primary reason for owning the house would be the recreation of the taxpayer. Regulation 1.183-1(b)(1)(ii) provides that deductions related to a rented vacation home cannot exceed the income realized less the amounts deductible even though not incurred in a business setting. The following illustration, based on the example in Regulation 1.183-1(d)(3), will show the tax effect in a typical situation:

Let us assume that a couple living in one of the metropolitan areas owns a summer cottage on a lake in Maine. They customarily spend one month at the lake property during the husband's annual vacation, and for two months during the peak of the recreational season they rent the property for $2,000 ($1,000 a month). As shown in the schedule below, the couple will lose a considerable tax benefit under the provisions of the new regulations:

	Prior Law		*Present Law*	
Rental Income	$2,000		$2,000	
	⅓	⅔	⅓	⅔
Expenses:	*Personal*	*Business*	*Personal*	*Business*
Interest (A)	400	800	400	800
Real Estate Taxes (A)	200	400	200	400
Maintenance		400		200 (B)
Utilities		200		
Depreciation		800		
Allowable Deductions	600	2,600	600	1,400
		600		600
		3,200		2,000
Net Deduction		1,200		-0-
Tax Savings @ Assumed Rate of 40%		480		-0-

(A) Fully deductible under Sections 163 and 164(a) regardless of whether lake property activity is engaged in for profit.

(B) Limitation under new regulations: rental income, $2,000 less interest and taxes $1,800 = $200.

REVIEWS

(Continued from page 19)

The research documents that, in general, distributions provide no real gain to stockholders. In the cases where definite price action from the close on the prior date to the opening on the ex-date existed, it was a result of mixing stock and cash dividends. Generally, stock distributions without cash dividends benefit the stockholders only negligibly and then only in those cases where the stock distribution is 5% or less.

With the exception of the statistical methodology, the article is easy to read, short, and to the point. It appears to lack sufficient strength to completely obliterate the AICPA's guideline; however, it does strengthen the position of stock dividend critics.

Boyd C. Greene, graduate student
Memphis State University

"Corporate Farming: A Tough Row to Hoe," Dan Cordtz, *Fortune*, Vol. LXXXVI, No. 2, August 1972.

Much has been written about the tragic demise of the "family farm." This article presents information which states that the demise has been in the farm with sales of less than $5,000 gross, yielding a net which is not sufficient to support a family. Since 1939 the number of farms with sales of $10,000 or more have tripled. At the same time, corporations which have been rushing into the farming business are discovering that "bigger is not better."

The author lists numerous corporations which have gone bankrupt or beat a hasty retreat into other ventures as they discover that "the shadow of the owner on his land" is the key to success. The struggle against nature, weather, soil, makes field decisions essential. "Growing food can probably be better left to real farmers, but the big corporate investors may yet find in distribution the profits that they have been pursuing in agriculture."

M.E.D.